

# Disallowance of Excess Business Losses Made Permanent

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On July 4, 2025, President Trump signed P.L. 119-21 into law, commonly known as the One Big Beautiful Bill Act (“OBBBA”). Most significantly, the OBBBA made permanent many taxpayer-favorable aspects of the 2017 law known as the Tax Cuts and Jobs Act, including the reduction in individual tax rates and a substantial increase in the lifetime gift and estate tax exclusion amount. However, one often-overlooked provision that was made permanent by the OBBBA could have a significant negative impact on certain taxpayers, particularly those in the rental real estate industry.

As a result of generous depreciation rules, the ownership of rental real estate often generates taxable losses each year. A variety of limitations exist to prevent taxpayers from using those losses against other income, but with exceptions that apply in certain circumstances. For example, taxpayers are generally prohibited from claiming deductions from an activity to the extent they are not “at risk” with respect to the activity. This generally limits losses attributable to nonrecourse debt, but an exception exists for certain qualified nonrecourse financing, which largely exempts real estate from these rules.

The “passive loss” rules are another important limitation on the use of losses. Those rules generally prevent a taxpayer from using passive losses (i.e., losses from activities in which the taxpayer does not materially participate) against the taxpayer’s income from non-passive activities and certain portfolio income such as interest, dividends, and royalties. For purposes of these rules, rental activities are generally considered passive activities without regard to whether the taxpayer materially participates. However, an exception exists for certain “real estate professionals,” which are defined as individuals who spend at least 750 hours per year and 50 percent of their business time per year in real estate activities. If an individual is a real estate professional, his rental real estate activities will not be subject to the passive loss rules if he is considered to materially participate in them (which generally requires spending 500 hours per year across all rental real estate activities).

Many rental real estate owners qualify for the real estate professional exception and thus are not subject to the passive loss rules. Prior to the 2017 law, they could generally deduct real estate losses against any other income, including portfolio income such as interest, dividends, and capital gains, as well as wages.

The 2017 law added section 461(l) to the Internal Revenue Code, which limited taxpayers’ ability to use losses from trades or business against other types of income, such as portfolio income and wages, to \$250,000 per year (or \$500,000 in the case of a married couple filing jointly), with annual inflation adjustments.

Section 461(l) was originally written to apply to tax years from 2018 through 2025. However, various subsequent laws delayed its effective date to 2021 and extended it through 2028. The OBBBA removed the scheduled expiration date of section 461(l) and also reset the inflation adjustments so that the thresholds are reduced once again to \$250,000 for the 2025 tax year (or \$500,000 for a joint return). Thus, taxpayers will have to live with section 461(l) for the foreseeable future.

To illustrate how section 461(l) operates, consider an unmarried taxpayer who has a \$1 million taxable loss from a real estate business and \$1 million of interest and dividend income in 2025. In the absence of section 461(l), the taxpayer would have no taxable income or loss. With the application of section 461(l), the taxpayer can use the loss against only \$250,000 of the portfolio income and has net taxable income of \$750,000. The remaining \$750,000 of business losses is disallowed in the current year.

Any losses disallowed by section 461(l) may be carried forward but are not again subject to section 461(l) in a subsequent year; instead, such losses are treated as net operating loss (“NOL”) carryforwards in subsequent years. Under post-2017 law, most NOL carryforwards can only be used to offset up to 80% of a taxpayer’s taxable income, and most unused NOLs can be carried forward indefinitely. Thus, on the federal level, section 461(l) is primarily a timing restriction rather than a permanent disallowance of losses.

The interaction of section 461(l) and various state and local tax rules can often lead to strange results. For example, assume that an unmarried taxpayer has \$1 million of business losses for the taxable year, which include bonus depreciation deductions, and no taxable income. For federal purposes, section 461(l) does not have much effect, since the taxpayer has no income to use the losses against. However, because of section 461(l), the taxpayer technically has an adjusted gross income (“AGI”) of negative \$250,000 rather than negative \$1,000,000.

This can have important state and local tax consequences. The starting point for determining a taxpayer’s income subject to New York State tax is federal AGI, which is then increased or decreased by certain New York-specific adjustments. For example, federal bonus depreciation and gain deferred by investing in qualified opportunity funds are added to federal AGI to determine New York State AGI. In the example described above, federal AGI is less negative because of section 461(l), which means that the taxpayer could potentially have positive taxable income for New York State purposes, and thus owe New York State tax, even if he would not have owed tax had he not claimed bonus depreciation. Depending on the circumstances, such a taxpayer might be better off electing out of bonus depreciation and foregoing the associated federal benefits.

In sum, section 461(l) can significantly complicate individual tax planning for real estate investors, particularly in situations where there are meaningful differences between a taxpayer’s income for federal and state purposes. Now that it no longer has a scheduled expiration date, taxpayers will need to be especially mindful of section 461(l) since it may be with us for many years to come.

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